



New Issue: [Puerto Rico Sales Tax Financing Corporation](#)

**MOODY'S ASSIGNS A2 TO PUERTO RICO SUBORDINATE LIEN SALES TAX REVENUE BONDS; UPGRADES SENIOR LIEN SALES TAX BONDS TO Aa3**

**PUERTO RICO SALES TAX FINANCING CORPORATION HAS \$5.2 BILLION IN SENIOR REVENUE BONDS OUTSTANDING**

Puerto Rico (Commonwealth of)  
State  
PR

**Moody's Rating**

ISSUE	RATING
Sales Tax Revenue Bonds, First Subordinate Series 2009 A	A2
<b>Sale Amount</b>	\$6,000,000,000
<b>Expected Sale Date</b>	05/28/09
<b>Rating Description</b>	Revenue

**Opinion**

NEW YORK, May 18, 2009 -- Moody's Investors Service has assigned an A2 rating and stable outlook to the Puerto Rico Sales Tax Financing Corporation's (COFINA) Sales Tax Revenue Bonds, First Subordinate Series 2009A, to be issued in an amount up to \$6 billion. At the same time, we have upgraded the Puerto Rico Sales Tax Financing Corporation Senior Sales Tax Revenue Bonds to Aa3 from A1.

The upgrade to the outstanding senior lien bonds reflects structural changes made to the bond resolution that include increasing the portion of the sales tax that is pledged to the bonds. The changes also reflect provisions that have been put in place by the legislature to restrict the ability to decrease or replace the portion of the sales tax that is not pledged to the bonds but provides debt service coverage. In addition, the upgrade reflects the performance of the sales tax since its inception in November 2006. The rating on the subordinate bonds reflects the additional bonds test and the potential coverage if both liens are fully leveraged. The constraints on issuance provide capacity to issue over \$7 billion in bonds. The rating anticipates fully leveraging the program.

The proceeds of the Series 2009A bonds will be used to provide funds to the Commonwealth of Puerto Rico to be applied to the repayment of certain debt obligations, to fund a local economic stimulus plan, and to reduce the fiscal 2009 and 2010 budgetary deficit, among other purposes.

The high-quality ratings on the senior and subordinate bonds reflect the following strengths and challenges:

**CREDIT STRENGTHS**

- \* A strong legal structure, including a pledge of the larger of either 2.75% of the commonwealth's 7% sales tax or a minimum, fixed base amount, and a collection mechanism that segregates those monies from the General Fund.
- \* A broad and diversified economic base that supports the sales tax pledge, including many products and services but excluding the more volatile sectors of automobiles and energy, and strong long-term growth of personal consumption expenditures.
- \* Non-impairment covenant by the commonwealth; legal opinions that the pledged sales tax revenues are not available to its General Fund.
- \* For the senior bonds, more than 2 times coverage by the pledged revenues, and more than 5 times coverage by all projected sales tax revenues; for the senior and subordinate bonds together, more than 1 times coverage by the pledged revenues and 2 times coverage by all revenues.

**CREDIT CHALLENGES**

- \* The tax is relatively new and its performance during prolonged global economic downturns is unclear
- \* Coverage could fall if growth in the sales tax is less than expected, or depth and duration of the commonwealth's recession is greater than expected.
- \* Legislature could change the sales tax to decrease available revenues, although recent legislation would make this more difficult.
- \* Collections and enforcement appear to be lax.

**THE SALES TAX**

The 7% sales tax was implemented in Puerto Rico in November 2006. The tax applies to most goods and services, but excludes some of the more volatile sectors, such as automobiles and energy. The sales tax does not depend heavily on the tourism industry, which overall makes up less than 10% of the economic activity in the commonwealth. The 29 months of sales tax collections history show the tax has thus far been relatively stable, and has not experienced declines similar to the recent experience in many states.

It has recently been estimated in Puerto Rico that enforcement efforts have not been strong, and that the commonwealth may only be collecting approximately 60% of the sales tax it could be collecting. The commonwealth has plans to improve its collections and enforcement, which could provide additional revenues.

**SALES TAX BONDS-THE OLD STRUCTURE**

Of the 7% sales tax that is levied in Puerto Rico, 1.5% goes to municipalities. Of the remaining 5.5%, the original structure dedicated 1% to COFINA's sales tax bonds. Under that structure, \$5.2 billion of revenue bonds were issued in 2007 and 2008. The bonds were secured by the pledged revenues, which were defined as 1% of the sales tax, or a "base amount," which was initially set at \$185 million, increasing by 4% per year thereafter. The collection and retention process includes several strong structural features. Of the 5.5% of the sales tax not dedicated to municipalities, the first dollars collected in any fiscal year are retained by COFINA until an amount sufficient for annual debt service is accumulated; only after that set-aside is any sales tax released to the commonwealth's General Fund. Thus, the sales tax provides 1 times coverage from pledged revenues, but 5.5 times coverage from all available revenues. Additional bonds could not be issued if debt service on all bonds in any year was greater than base amount in that year. This provided the capacity to issue approximately \$6.5 billion. The structure was deemed to "pierce the general obligation ceiling" because it met the requirements laid out in our 2008 methodology report "Piercing the G.O. Ceiling."

#### NEW STRUCTURE ADDS SUBORDINATE BONDS, STRENGTHENS SENIOR BONDS

The new structure is based on legislation that was passed in early 2009 and an amendment to the governing resolution. Legislation has increased the portion of the sales tax revenues that are pledged to the bonds from 1% to 2.75%, and allows subordinate bonds to be issued. For the new senior and subordinate bonds, the pledged revenues are the larger of 2.75% of the sales tax or the "base amount." The new base amount is \$550 million in 2010, which will increase annually by 4% until a cap of \$1.85 billion is reached. Under the new structure, as sales tax revenues are collected, the first \$550 million go directly to the COFINA debt service fund. After the base amount has been collected, sales tax revenues will go to the General Fund. Once the General Fund has collected \$550 million (escalating at 4% annually from 2010), each additional dollar collected is split 50/50 between COFINA and the General Fund.

For additional senior bonds to be sold, they must meet the original additional bonds test (ABT), which requires that debt service on the senior bonds not be greater than the original base amount (\$185 million in 2008, growing at 4% per year). While this does not close the lien on the senior bonds, it limits senior issuance to within the original leverage constraint. For subordinate bonds to be issued, combined debt service on senior and subordinate bonds must always be less than the new base amount, and the 5.5% of available sales tax must be at least 2 times debt service.

Under the new structure, the senior bonds have more than 2 times coverage from pledged revenues (as opposed to 1 times coverage under the old structure), and still more than 5 times coverage from all available sales tax revenues. The senior and subordinate bonds together are now expected to have 1 times coverage from the pledged revenues, and 2 times coverage from all available revenues

#### FLOW OF FUNDS REQUIRES DAILY REVENUE TRANSFERS TO TRUSTEE

Merchants and retailers pay the sales taxes on a monthly basis to Banco Popular or another authorized collection agent. Daily, the collection agent transfers the money to a bridge account at Banco Popular in the name of the Treasury Department. Banco Popular then transfers money on a daily basis (with a two-day delay) to the trustee until the base amount has been deposited into the revenue account. After the base amount has been deposited, the revenues are required to be transferred daily to the Treasury Department's account at the Government Development Bank, until the Treasury Department's account has received its share (2.75%/5.5%) of the collections received to date in the fiscal year. After that time, GDB is responsible for dividing the additional receipts of the sales tax between the Sales Tax Revenue Account and the Treasury Account on the basis of the 50/50 split.

#### COVERAGE STRONG EVEN IN STRESS SCENARIOS

The first claim on all sales tax revenues is expected to provide healthy coverage of debt service even in stress scenarios. While personal consumption expenditures in Puerto Rico (a proxy for sales tax revenues) have grown at an average annual rate of 7.6% over the past 60 years, much more conservative assumptions were used to calculate coverage.

For example, if there is no growth in sales tax revenues through 2054 and the senior lien is fully leveraged, 1 times coverage of debt service can still be maintained. If there is no growth in sales tax revenues for 15 years, and then growth of 3.8% per year thereafter and both liens are fully leveraged, 1 times coverage is maintained for both the senior and the subordinate bonds. Growth of only 1.6% per year provides just over 1 times coverage of all bonds. A 10% decline in collections in 2011, 2012, and 2013, followed by growth of 3.8% per year thereafter still results in 1.3 times coverage of all bonds' debt service.

Our assumptions of debt service coverage do not include any estimates of population increases over the next 50 years, and do not assume any increases in sales tax revenues due to increased collection enforcement.

#### CHANGES TO SALES TAX LESS LIKELY THROUGH STRENGTHENED NON-IMPAIRMENT PROVISIONS

On February 6, 2008, the former Governor of the Commonwealth of Puerto Rico announced a plan to suspend the collection of a portion of the sales tax, with the result of reducing the sales tax rate from the current 7% to 2.5%. The reduction in the sales tax would have left 1.5% sales tax available to the municipalities, and 1% dedicated to the Sales Tax Revenue Bonds. The 4.5% in sales tax revenues that previously went to the General Fund would not have been collected. The governor proposed replacing the lost revenues with an excise tax. This proposal was never implemented.

In 2009, a change was made that makes it more difficult for the commonwealth to change the sales tax in the future. Under the revised bond resolution, the sales tax may only be lowered or abolished (and only the portion that is not pledged first to COFINA) if it is replaced with a "like or comparable security," and if the trustee has been provided with (i) written confirmation of all outstanding ratings of the bonds

from the applicable rating agencies, taking such substitution into account, and (ii) written opinions of the Secretary of Justice, nationally recognized bond counsel, and Puerto Rico counsel expert in public finance matters, each concluding that the Puerto Rico Supreme Court, if properly presented with the issue, would conclude that the substituted assets and revenues have been validly imposed by law, have been validly transferred to COFINA and do not constitute "available resources" of the commonwealth for purposes of the "clawback" provision of the constitution.

#### REVENUES NOT SUBJECT TO COMMONWEALTH "CLAWBACK"

We note that the rating on the senior and subordinate Sales Tax Revenue Bonds is significantly higher than our current Baa3/stable rating on the commonwealth's general obligation bonds, primarily reflecting our assessment of the strength of the pledged sales tax security, as well as the fact that the sales tax revenues are not subject to the commonwealth's "clawback" provisions (according to opinions issued by the commonwealth's Secretary of Justice and outside bond counsel). Importantly, we view the sales tax pledge to be insulated from the commonwealth's broader budget and financial problems that have caused the downgrading of the G.O. bonds to their current low investment-grade level.

#### MOST RECENT RATING ACTION AND PRINCIPAL METHODOLOGY

The Puerto Rico Sales Tax Financing Corporation's Sales Tax Revenue Bonds' rating was assigned by evaluating factors believed to be relevant to the credit profile of the Puerto Rico Sales Tax Financing Corporation, such as i) the business risk and competitive position of the issuer versus others within its industry or sector, ii) the capital structure and financial risk of the issuer, iii) the projected performance of the issuer over the near to intermediate term, iv) the issuer's history of achieving consistent operating performance and meeting budget or financial plan goals, v) the nature of the dedicated revenue stream pledged to the bonds, vi) the debt service coverage provided by such revenue stream, vii) the legal structure that documents the revenue stream and the source of payment, and viii) and the issuer's management and governance structure related to payment. These attributes were compared against other issuers both within and outside of the Puerto Rico Sales Tax Financing Corporation's core peer group, and Puerto Rico Sales Tax Financing Corporation ratings are believed to be comparable to ratings assigned to other issuers of similar credit risk.

The last rating action with respect to the Puerto Rico Sales Tax Financing Corporation was on June 19, 2008, when a rating of A1 was assigned to the Sales Tax Revenue Bonds, Series 2008A.

#### Outlook

The rating outlook for the Sales Tax Revenue Bonds is stable. The outlook reflects the expected stability of the sales tax revenues, as well as the separation in the structure between the credit and the commonwealth.

What could change the rating-UP

- Dramatic growth in sales tax revenues, leading to a significant increase in coverage
- Increase in the sales tax rate without increasing ability to leverage bonds
- Increase in portion of sales tax dedicated to the bonds without increasing ability to leverage

What could change the rating-DOWN

- Decline in sales tax revenues, leading to decreased coverage
- Legislative change to sales tax that decreases available revenues

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